INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Summary of argument	6
Argument:	
Federal tax liens on funds due a contractor are superior to the claims of subcontractors asserted under New York law where the subcontractors had not filed notices of their liens until after the federal tax liens came into existence	9
A. The indebtedness of the owner to the taxpayer constituted property of the latter (to which the federal tax liens attached), notwithstanding that New York treats such indebtedness as a "trust fund" for the benefit of subcontractors and materialmen	11
B. The fund deposited by the owner in court constituted property of the taxpayer to which the federal tax lien attached	22
C. There is no occasion here for re-examination of the settled rule that federal liens have priority over previously filed state-created mechanic's liens which require further steps for their perfection	23
Conclusion	25
Appendix	26

CITATIONS

Cases:	
Arkansas v. *Texas*, 346 U.S. 368	13
Corbin-Kellogg Agency v. *Tasker*, 248 App. Div. 58	18
Fidelity & Deposit Co. v. *New York City Housing Authority*, 241 F. 2d 142	14, 21

Cases—Continued Page

General Trading Co. v. *Tax Commission*, 322 U.S. 335 13
Gramatan-Sullivan, Inc. v. *Koslow*, 240 F. 2d 523, certiorari denied, 353 U.S. 958 15, 17
Herrmann & Grace v. *Hillman*, 203 N.Y. 435 19
Musser v. *Utah*, 333 U.S. 95 7, 13
Raymond Concrete Pile Co. v. *Federation Bank*, 288 N.Y. 452 15, 16, 18
Saltser & Weinsier, Inc. v. *Monroe Plumbing & Heating Supply Corp.*, 290 N.Y. 903 15, 17
Speiser v. *Randall*, 357 U.S. 513 13
United States v. *Acri*, 348 U.S. 211 9
United States v. *Bess*, 357 U.S. 51 13, 20
United States v. *Colotta*, 350 U.S. 808, reversing 224 Miss. 33 9
United States v. *Durham Lumber Co.*, 257 F. 2d 570, pending on certiorari, No. 23, this Term 20, 23
United States v. *Hulley*, 358 U.S. 66, reversing 102 So. 2d 599 9
United States v. *Kings County Iron Wor[illegible]* 224 F. 2d 232 14, 20, 21
United States v. *Liverpool & London Ins. Co.*, 348 U.S. 215 9
United States v. *New Britain*, 347 U.S. 81 9, 11, 24
United States v. *Scovil*, 348 U.S. 218 9
United States v. *Security Tr. & Sav. Bk.*, 340 U.S. 47 9
United States v. *Vorreiter*, 355 U.S. 15, reversing 134 Col. 543 9
United States v. *White Bear Brewing Co.*, 350 U.S. 1010, reversing 227 F. 2d 359 9
Van Clief v. *Van Vechten*, 130 N.Y. 571 19
Washington Square Slum Clearance, In re, 5 N.Y. 2d 300, pending on petition for a writ of certiorari *sub nom. United States* v. *Coblentz*, No. 259, this Term 14
Wickes Boiler Co. v. *Godfrey-Keeler Co.*, 121 F. 2d 415, certiorari denied, 314 U.S. 686 19

Statutes:

Internal Revenue Code of 1939:
Sec. 3670 (26 U.S.C. 1952 ed., Sec. 3670) 2, 5, 6, 11, 13, 14, 26
Sec. 3671 (26 U.S.C. 1952 ed., Sec. 3671) 2, 6, 11, 26
Sec. 3672 (26 U.S.C. 1952 ed., Sec. 3672) 2, 12, 26

COPY BOUND CLOSE IN CENTER

Statutes—Continued

New York Lien Law, 32 McKinney's Consolidated Laws of New York:

	Page
Sec. 3	2, 27
Sec. 4(1)	2, 27
Sec. 13	18
Sec. 13(7)	2, 28
Sec. 25-a	15, 16
Sec. 36-a	2, 29

COPY BOUND CLOSE IN CENTER

n the Supreme Court of the United States

OCTOBER TERM, 1959

No. 1

ROBERT AQUILINO, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA, ET AL.

VRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

ıe opinion of the New York Court of Appeals 65–70) is reported at 3 N.Y. 2d 511. The opinion he Appellate Division of the Supreme Court of York (R. 62–64) is reported at 2 App. Div. 2d The opinion of the Supreme Court, Westchester ıty (R. 52–53), is reported at 140 N.Y.S. 2d 355.

JURISDICTION

e judgment of the Court of Appeals was entered ecember 5, 1957. (R. 70–72.) An order denying tion for reargument but amending the remittitur entered on April 15, 1958. (R. 72–73.) The on for a writ of certiorari was filed on June 27, and was granted on February 24, 1959. (R. 82.)

The jurisdiction of this Court rests on 28 U.S.C 1257(3).

QUESTION PRESENTED

Whether the New York Court of Appeals correctl held that under New York law the indebtedness of a owner of realty to a building contractor constitute "property" of the latter to which federal tax lien attach.

STATUTES INVOLVED

Sections 3670, 3671, and 3672(a) of the Interna Revenue Code of 1939 and Sections 3, 4(1), 13(7) an 36-a of the New York Lien Law are set forth in th Appendix, *infra*, pp. 26–30.

STATEMENT

This case arises out of actions instituted by tw subcontractors, petitioners here, to enforce mechanic liens against a fund due to the contractor for whom they furnished labor or materials at a time when there were outstanding federal tax liens against such con tractor for unpaid withholding taxes.[1] While non of the courts below entered findings of fact, the fact are undisputed and may be briefly summarized a follows:

The taxpayer, Fleetwood Paving Corporatio ("Fleetwood"), was a general contractor who was i default in the payment of federal withholding taxe (R. 65.) On December 27, 1951, the Collector of In ternal Revenue received an assessment against suc taxpayer for unpaid withholding taxes plus interes

[1] The actions were consolidated for hearing in the cour below. (R. 42.)

COPY BOUND CLOSE IN CENTER

in the amount of $4,464.70, and on March 21, 1952, the Collector received a further assessment in the amount of $3,168.11. (R. 46, 49.) On October 31, 1952, the Collector filed notice of the federal tax liens in the office of the city clerk of the City of Mount Vernon, New York, where taxpayer had its place of business. The total amount of such liens was $5,632.81, consisting of $355.30 of the first assessment remaining unpaid as well as the entire amount of the second assessment, together with unassessed interest and penalties. (R. 47, 49, 51.)

In July or August, 1952, the taxpayer contracted with Ada C. Bottone to remodel a restaurant which she had purchased earlier that month. (R. 43, 65.) On August 25, 1952, petitioners Aquilino and Spero entered into a contract with Fleetwood to furnish certain labor and materials for use in such work. Aquilino and Spero performed their subcontract, but received payment of only $1,000 out of the full subcontract price of $2,400, leaving a balance due them of $1,400. (R. 10–11, 65, 66.) Similarly, between October 2, 1952, and October 8, 1952, petitioner Colonial Sand and Stone Company, Inc. ("Colonial"), furnished certain materials to Fleetwood for an agreed price of $896.25, no part of which has been paid. (R. 40.)

On November 3, 1952 (after the federal liens had been filed), petitioners Aquilino and Spero filed a notice of their mechanic's lien for $1,400 in the office of the county clerk of Westchester County, where the real estate was located (R. 11, 66). On November 10, 1952, petitioner Colonial filed its lien (for

$896.25) in the same office (R. 40, 66). Copies of such notices of lien were served upon the owner and Fleetwood by Aquilino and Spero on November 6, 1952 (R. 12), and by Colonial on November 12, 1952 (R. 41).

In June 1953, separate actions to foreclose their liens were instituted in the New York Supreme Court by petitioner Colonial, and by petitioners Aquilino and Spero (R. 15–20, 22–27, 41). The owner filed an answer admitting that $2,200 remained due and unpaid under her contract with Fleetwood (R. 28–29), and by order entered July 28, 1954, she was permitted to deposit this sum with the clerk of Westchester County and was thereupon discharged from further liability to the petitioners, and the United States was ordered substituted as a defendant in both actions. (R. 32–33.)

The United States served answers in both actions alleging that its tax liens had priority over the mechanic's liens (R. 33–38). Petitioners then moved for summary judgment foreclosing their mechanic's liens, and the United States cross-moved for summary judgment (R. 8–9, 38–39, 45–51). The court granted petitioners' motions and denied that of the United States. It held (R. 52–53) that the lien of the United States was not effective because it should have been filed in the office of the county clerk as a lien against real property rather than in the office of the city clerk of Mount Vernon as a lien against personal property; and that petitioners were entitled to priority as statutory assignees of a

COPY BOUND CLOSE IN CENTER

taxpayer whose claims were prior to those of the United States.

The Appellate Division affirmed on another ground. It ruled that when the federal liens arose no debt was owing from the owner to the contractor; that when such debt came into existence it was already encumbered by petitioners' mechanic's liens; and that the United States stood in the same position as the contractor, namely, it had a claim only after petitioners had been paid. (R. 62–64.)

The New York Court of Appeals (*per* Judge Fuld, Judge Van Voorhis dissenting without opinion) reversed. It pointed out that the federal tax liens were not asserted against real property of either the owner or the taxpayer, but against the owner's "contractual obligation" to the taxpayer (R. 68); that such indebtedness was "quite obviously" "personal 'property and rights to [such] property' belonging to the taxpayer" within the meaning of Section 3670 of the Internal Revenue Code of 1939 (R. 68); and that since the federal liens had been filed before petitioners filed their mechanic's liens, the federal liens were "entitled to priority" under the "firmly established" rule that "once a government tax lien is properly filed, no subsequently recorded lien or claim may prevail against it" (R. 67). The court further held (R. 68–69) that since "no state-created rule may defeat the paramount right of the United States to levy and collect taxes uniformly throughout the land," the provision of the state's lien law upon which petitioners relied—"that funds received by a

524826—59——2

contractor from the owner for the improvement of real estate shall be deemed 'trust funds' for the payment of subcontractors"—"may not be construed to affect the rights of the government or the priority of its tax lien."

Petitioners sought reargument, on the ground that the court had "overlooked their fundamental argument" (R. 76) that "no interest in the property involved existed under the law of the State of New York in favor of the defendant Fleetwood Paving Corporation, and that therefore there is no 'property or right to (such) property' to which a Federal tax lien can attach under United States Code, Title 26, Sec. 3670" (R. 77). The court denied reargument (R. 72–73).

SUMMARY OF ARGUMENT

A. Section 3670 of the Internal Revenue Code of 1939 provides that a lien for federal taxes shall attach to "all property and rights to property" of the taxpayer, and Section 3671 provides that the federal lien shall arise at the time the assessment list is received by the Collector. The assessment lists giving rise to the federal liens here involved were received on December 27, 1951, and March 21, 1952, and were recorded on October 31, 1952, whereas the petitioners did not perform labor or furnish materials before August, 1952, and did not file notices of their mechanic's liens until November, 1952.

It is well settled that federal tax liens have priority over subsequently filed mechanic's liens. Applying this principle, the New York Court of Appeals ruled

COPY BOUND CLOSE IN CENTER

hat whether the federal lien had priority, therefore, depends solely on whether the indebtedness due to the taxpayer] from [the owner] constituted property of [the taxpayer]" (R. 68). The court held (*ibid*) that, even though the New York Lien Law created the indebtedness from an owner to a contractor as a "trust fund" for the benefit of subcontractors and materialmen, such indebtedness was "quite obviously * * * personal 'property and rights to [such] property' belonging to the taxpayer." "What the statutes of a State mean, the extent to which any provision may be limited by other acts * * * are questions on which the highest court of the State has the final word." *Musser* v. *Utah*, 333 U.S. 95, 98.

Petitioners, although recognizing that whether the owner's indebtedness to the contractor was property or the latter is a question of state law, contend that in deciding the question the New York Court of Appeals applied federal rather than state law. But it cannot be assumed, as petitioners do, that because the New York court cited two decisions of the Court of Appeals for the Second Circuit rather than any New York cases for what it deemed to be a "quite obvious" proposition, that it applied the wrong law. A subsequent decision of the court below, also involving the priority of a federal tax lien, makes it clear beyond doubt that in this case the Court of Appeals did decide the question on the basis of state law.

In any event, prior decisions of the New York Court of Appeals and of the Court of Appeals for the Second Circuit establish that New York law does

not treat the owner's indebtedness to the contractor as a true trust, and that the "trust fund" doctrine does not deprive the contractor of any property interest in the funds due him from the owner. In the circumstances, the court below correctly held that the owner's indebtedness to the contractor constitutes "property" of the latter to which the federal tax lien attached.

B. As an alternative argument, petitioners urge that the federal tax liens did not attach to the fund in suit for the reason that such fund was the property of the owner, not the taxpayer. This argument is premised upon the theory that they also had liens against the real property of the owner and that the fund was deposited in court in substitution therefor. This argument, rejected by the court below, overlooks the fact that the fund here involved represented the debt due the taxpayer from the owner and that the liens claimed by the petitioners are predicated upon the existence of that debt. Consequently, the fund deposited constituted property of the taxpayer to which the federal liens necessarily attached.

C. Finally, petitioners urge that this Court should re-examine the settled rule that a federal tax lien has priority over a previously filed mechanic's lien if the latter is "inchoate" in the sense that additional steps are required to perfect. While we believe that the rule is correct and that petitioners have shown nothing which warrants its re-examination, it would clearly not be appropriate to do so in the instant case. For here the federal tax liens arose many

COPY BOUND CLOSE IN CENTER

months before the subcontractors asserted any claims, and were properly recorded prior to the filing of petitioners' liens. This case, therefore, is governed by the principle—which petitioners do not challenge—that "the first in time is the first in right" (*United States* v. *New Britain,* 347 U.S. 81, 85). Since petitioners' liens were not "the first in time", they could not prevail even if inchoate state liens were to be treated as prior to subsequently filed federal liens.

ARGUMENT

FEDERAL TAX LIENS ON FUNDS DUE A CONTRACTOR ARE SUPERIOR TO THE CLAIMS OF SUBCONTRACTORS ASSERTED UNDER NEW YORK LAW WHERE THE SUBCONTRACTORS HAD NOT FILED NOTICES OF THEIR LIENS UNTIL AFTER THE FEDERAL TAX LIENS CAME INTO EXISTENCE

It is now "firmly established" (R. 67) that federal tax liens are entitled to priority over subsequently recorded mechanic's liens, or over previously recorded mechanic's liens, if further steps are required to perfect them. *United States* v. *Hulley,* 358 U.S. 66, summarily reversing 102 So. 2d 599 (Fla.); *United States* v. *White Bear Brewing Co.,* 350 U.S. 1010, summarily reversing 227 F. 2d 359 (C.A. 7); *United States* v. *Vorreiter,* 355 U.S. 15, summarily reversing 134 Colo. 543; *United States* v. *Colotta,* 350 U.S. 808, summarily reversing 224 Miss. 33; *United States* v. *Scovil,* 348 U.S. 218; *United States* v. *Acri,* 348 U.S. 211; *United States* v. *Liverpool & London Ins. Co.,* 348 U.S. 215; *United States* v. *New Britain,* 347 U.S. 81; *United States* v. *Security Tr. & Sav. Bk.,* 340 U.S. 47. In the instant case, the federal tax liens came into ex-

istence many months before any claims were asserted by the subcontractors, and indeed many months before the subcontractors furnished the labor or materials which formed the basis for their claims. Under these settled principles, therefore, it would seem no longer open to question that the federal tax liens are entitled to priority over the claims of the subcontractors.

Although petitioners now suggest (Br. 27–34) that these settled principles should be reexamined (see discussion *infra,* pp. 23–24), their major argument involves only a question of state law. They contend (Br. 11–25) that since New York treats a contractor's claim against an owner as a "trust fund" for the benefit of subcontractors and materialmen, the Court of Appeals erred in holding that this claim constitutes "property" of the contractor to which the federal liens attached. But the interpretation of state law by the highest court of the state is binding upon this Court; in any event, as we shall show, under New York law the owner's indebtedness to the contractor is "property" of the latter. We shall further show that the federal lien cannot be defeated on the theory that the fund paid into court by the owner is merely in substitution for the real property itself, and therefore is not subject to the federal lien (which is on the indebtedness). Finally, we shall show that there is no occasion for reexamining this Court's prior decisions that federal liens have priority over inchoate state liens, since even the contrary rule would not give petitioners' liens priority in this case.

COPY BOUND CLOSE IN CENTER

A. THE INDEBTEDNESS OF THE OWNER TO THE TAXPAYER CONSTITUTED PROPERTY OF THE LATTER (TO WHICH THE FEDERAL TAX LIENS ATTACHED), NOTWITHSTANDING THAT NEW YORK TREATS SUCH INDEBTEDNESS AS A "TRUST FUND" FOR THE BENEFIT OF SUBCONTRACTORS AND MATERIALMEN

1. Section 3670 of the Internal Revenue Code of 1939 (Appendix, *infra,* p. 26) provides that if any person liable to pay any tax neglects or refuses to pay such tax after demand, the amount thereof (together with any additions thereto) "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person". Section 3671 (Appendix, *infra,* p. 26) provides that unless another date is specifically fixed by law, the lien shall "arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time."

The assessment lists for the federal taxes here in question were received on December 27, 1951, and March 21, 1952 (R. 46), and, by virtue of the provisions of Section 3671, the federal tax liens became "perfected" on those dates. *United States* v. *New Britain,* 347 U.S. 81, 84. In July or August 1952, the taxpayer entered into a contract for improvements on property owned by Bottone and in early October, 1952, petitioner Colonial furnished materials to Fleetwood. (R. 40, 65–66.) On October 31, 1952, the United States filed notice of its liens in the office pro-

vided by state law. (R. 66.)[2] No claims were asserted by the petitioners until November, 1952, when they filed their liens. (R. 11, 40.)

The Court of Appeals held that it is "firmly established" by federal decisions that "once a government tax lien is properly filed, no subsequently recorded lien or claim may prevail against it" (R. 67), and that under state law the government's lien, "concededly filed * * * before the [petitioners] filed their notices," "is indisputably effective against all personal property and rights thereto belonging to the taxpayer (Lien Law, § 240, subd. 2)" (R. 68). It therefore ruled (*ibid.*) that "decision herein depends solely on whether the indebtedness due to Fleetwood from Bottone constituted property of Fleetwood." The court stated (*ibid.*) that the federal lien "was manifestly not asserted against Bottone's real property or any realty possibly owned by the taxpayer," but "was asserted against the contractual obligation of Bottone to Fleetwood." It concluded (*ibid.*) that, despite the provision in the state's lien law upon which petitioners relied—"that funds received by a contractor from the owner for the improvement of real property shall be deemed 'trust funds' for the payment of subcontractors (§ 36-a; § 13, subd. [7]"—this "indebtedness" from Bottone

[2] While this filing antedated the assertion of claims by petitioners, it was not essential to the validity of the federal tax liens. Under Section 3672 of the 1939 Code (Appendix, *infra*, p. 26), such filing is required only as against mortgagees, pledgees, purchasers and judgment creditors. The claims of the petitioners do not fall within any of these categories.

COPY BOUND CLOSE IN CENTER

to the taxpayer was "quite obviously * * * personal 'property and rights to [such] property' belonging to the taxpayer" within the meaning of Section 3670 of the 1939 Internal Revenue Code.

In short, the Court of Appeals held that, despite the fact that New York treats the owner's indebtedness to the contractor as a "trust fund" for the benefit of subcontractors and materialmen, such indebtedness is "property and rights to property" of the taxpayer, to which the federal tax lien attaches. "What the statutes of a State mean, the extent to which any provision may be limited by other Acts * * * are questions on which the highest court of the State has the final word." *Musser* v. *Utah,* 333 U.S. 95, 98; see also, *Speiser* v. *Randall,* 357 U.S. 513, 519; *General Trading Co.* v. *Tax Commission,* 322 U.S. 335, 337; *Arkansas* v. *Texas,* 346 U.S. 368, 371.

2. Petitioners recognize (Br. 10–13), as indeed they must (see *United States* v. *Bess,* 357 U.S. 51), that whether Fleetwood had a property interest in the sum due from Bottone is a question of state law. They contend (Br. 13, 18–20), however, that the Court of Appeals' decision of the question rested on the court's application of federal, rather than state, law; and that, because of the New York trust fund doctrine, state law does not treat the indebtedness as property of the contractor. Their argument is based on the fact that the Court of Appeals, in holding that the indebtedness is property, cited two decisions of the

Court of Appeals for the Second Circuit,[3] rather than any state cases.

But it cannot be presumed that because the New York court did not cite any state decisions for what it deemed to be a "quite obvious" proposition, it therefore applied the wrong law. Indeed, petitioner made precisely the same contention in seeking re argument in the Court of Appeals,[4] but the court denied the motion (R. 73). And, if there should be any doubt that the court applied state rather than federal law in ascertaining the extent of the taxpayer's property interests, it is dispelled by the court's subsequent decision in *In Re Washington Square Slum Clearance,* 5 N.Y. 2d 300, pending on petition for a writ of certiorari *sub nom. United States* v *Coblentz,* No. 259, this Term. There, in holding that an attorney's lien on part of the proceeds of a condemnation award had priority over a federal tax lien on the same proceeds, the court flatly stated (5 N.Y. 2d at 314) that "The determination of what constitutes property of a taxpayer on the date of the asserted lien

[3] *United States* v. *Kings County Iron Works*, 224 F. 2d 232 and *Fidelity & Deposit Co.* v. *New York City Housing Authority*, 241 F. 2d 142.

[4] They there stated (R. 76): "The Court, by citing Federal cases which purport only to classify for Federal purposes fundamental interests created by the law of the State of New York, assumes without further comment that such an interest exists under local law which a court may classify as 'property and rights to (such) property' within the terms of Title 26 Sec. 3670, United States Code. In making this assumption respondents feel that the court overlooked their fundamental argument that no such interests exist under New York law (respondent Aquilino's brief, pp. 9–16)."

COPY BOUND CLOSE IN CENTER

by the Government is a matter of State law." As one of three authorities for this proposition, it cited its prior decision in the instant case.

3. In any event, the fact that New York law treats the indebtedness of an owner to a contractor as a "trust fund" for the benefit of subcontractors and materialmen does not make such indebtedness any the less "property" of the contractor. For the New York Court of Appeals has held that these statutory provisions for the protection of subcontractors and materialmen do not "create a real trust fund to remain such under any and all contingencies from the time the contractor * * * first received payment" from the owner; and that the contractor, therefore, has the right to use the funds received from the owner for his own purposes. *Raymond Concrete Pile Co.* v. *Federation Bank,* 288 N.Y. 452, 462; *Saltser & Weinsier, Inc.* v. *Monroe Plumbing & Heating Supply Corp.,* 290 N.Y. 903. A like construction has been given the statute by the Court of Appeals for the Second Circuit in *Gramatan-Sullivan, Inc.* v. *Koslow,* 240 F. 2d 523, certiorari denied, 353 U.S. 958.

In the *Raymond* case the question was whether the defendant bank had the right to apply funds received by a contractor from the owner for public improvement construction, and deposited in the bank, to the satisfaction of the contractor's indebtedness to the bank, notwithstanding the claims of subcontractors.[5] The court held that, in the absence of direct notice of any claims by subcontractors, the bank had the right

[5] In that case the court was concerned primarily with the provisions of Section 25–a of the New York Lien Law creat-

to apply the sums received by the contractors to th satisfaction of its own claim. It ruled that the stat ute did not create a "real trust" under any and al circumstances from the time the contractor first re ceived payment, and that it did not bar the contracto from using the funds received for any purpose h saw fit, provided that he ultimately paid the subcon tractors out of other funds. The court stated (pp 459, 462):

> The most that the statute does or was designe to do in that respect is to create the possibilit of a fiduciary relationship arising between th contractor as to funds coming into his hand from a public improvement contract and a pos sible subcontractor or possibly others desig nated. * * * Nothing in the section bars th contractor from using the moneys received fo any purpose he may see fit provided he doe not fail to pay all such claims out of othe moneys which he may then have or which h may afterwards receive; and nothing in th section bars a banker from applying moneys if on deposit in the contractor's account at th bank, without inquiry, upon the contractor' indebtedness to the bank. It necessarily fol lows that no trust arises under that sectio from the mere fact that the contractor received and has in his hands moneys in payment o account of a public improvement.
>
> * * * * *

---

ing a trust fund of moneys received by a contractor on public improvements. The court noted, however, that the provisions of Section 25-a were identical to those of Section 36-a, here involved, applicable to private improvements. 288 N.Y., p 461.

COPY BOUND CLOSE IN CENTER

> In clear terms those sections [25–a, 25–b, 36–a, 36–b] were not intended to create a real trust fund to remain such under any and all contingencies from the time the contractor or subcontractor first received payment on account of public or private improvements respectively. * * *

In an analogous situation, involving a payment to the assignee of a creditor of the contractor to the prejudice of a subcontractor, a judgment in favor of the creditor's assignee was affirmed without opinion. *Saltser & Weinsier, Inc.* v. *Monroe Plumbing & Heating Supply Corp., supra.*

In *Gramatan-Sullivan, Inc.* v. *Koslow, supra,* the same problem was presented and contentions similar to those here advanced were there urged. The Court of Appeals, in an opinion by Judge Learned Hand, rejected the contention that the moneys received by the contractor constituted a trust fund for all purposes and could not be used except for the payment of existing future claims of subcontractors. It stated (240 F. 2d, p. 525):

> The plaintiff's position is that § 36–a makes all interim payments on a building job a trust fund, not only for the benefit of existing claims of "subcontractors," but of future claims that may arise thereafter as the work progresses. The contractor must keep intact all such payments save that he may pay claims of other "subcontractors" as they fall due. If he uses the payments for any other purpose, he is guilty of larceny, and anyone who receives them is liable, at least civilly to "subcontractors", present and future, if he knows, * * *. The privilege to pay claims as they mature, itself

> shows that the trust is not of the usual kind, for its exercise may result in giving earlier claimants a preference over later: e.g. if the contractor fails to earn any later payments. However, that privilege would not justify a privilege to use the payments for the contractor's own purposes, had not the section declared that a contractor is guilty of larceny, if he not only fails to apply the payments to the "claims of subcontractors" but that he also "fails to pay the claims". In short, if he pays the claims from other resources, he is not guilty of larceny, though he has used the payments for other purposes. * * *

Judge Hand then quoted extensively the language of the New York Court of Appeals in the *Raymond* case set forth *supra*.

These decisions of the New York courts, and of the federal appellate court in New York, authoritatively demonstrate that the trust fund doctrine does not have the effect of depriving the contractor of all property rights to the funds received from the owner.[6]

[6] Petitioners' citation of cases from lower New York courts dealing with the rights of judgment or other creditors to funds owed by the owner to a contractor (Br. 13–15) and of cases arising under the Bankruptcy Act (Br. 16–17) is inapposite. The cases holding that judgment creditors' rights are inferior to those of subcontractors were decided under Section 13 of the New York Lien Law, which expressly subordinates the liens of creditors, judgment creditors or attachment creditors, among others, to those of subcontractors, unless such creditors' claims arose from labor or material supplied to the same property. *Corbin-Kellogg Agency* v. *Tasker*, 248 App. Div. 58. Obviously, the New York statute does not purport to subordinate the claims of the United States arising under federal tax liens to those of subcontractors, nor could it

To the contrary, they show clearly that no real trust is created; that the contractor has the right to use the funds received for his own purposes, subject only to his obligation to pay the subcontractors out of other funds held by him or thereafter to be received by him; and that creditors may apply such funds to satisfy their claims against the owner. Moreover, in New York as elsewhere, the rights of the subcontractors are wholly dependent upon the existence of an indebtedness owing to the contractor by the owner. If no such indebtedness exists when the subcontractor files notice of his lien or thereafter, the subcontractor may not enforce his lien against the owner or his property. *Herrmann & Grace* v. *Hillman,* 203 N.Y. 435; *Van Clief* v. *Van Vechten,* 130 N.Y. 571.

In the instant case, therefore, Fleetwood would not have been precluded from using the funds due from the owner for its personal use, even though such funds are treated under New York law as a species of "trust fund" for the benefit of subcontractors and materialmen. In these circumstances, the court below correctly held that the taxpayer's

---

properly do so. The cases arising under the Bankruptcy Act would seem to involve the application of a similar theory. For since the rights of creditors are inferior to those of subcontractors, it could properly be reasoned that the rights of the trustee in bankruptcy, who represents such creditors and who occupies the position of a judgment creditor, are similarly inferior. Parenthetically, it may be noted that *Wickes Boiler Co.* v. *Godfrey-Keeler Co.*, 121 F. 2d 415 (C.A. 2), certiorari denied, 314 U.S. 686, did not involve the assertion of any priority by the Government, as petitioners assert. (Br. 16.) There is no indication that the Government was a party to that case.

right to the fund owing by the owner, Bottone, fell "quite obviously" within the federal statutory terms "property and rights to property" of the taxpayer. (R. 68.) Indeed, it is difficult to understand the basis for the contention that because the state has determined the priority in which various creditors are to be paid out of a fund due the taxpayer, the latter has no property interest therein to which the federal tax lien attaches. Here the state law does no more than provide that the owner's indebtedness to the taxpayer is to be used for paying certain of the latter's creditors; any rights such creditors have in the fund necessarily depend upon the taxpayer's interest therein.

In short, the federal tax liens attached to the owner's obligation to the taxpayer at a time when petitioners' claims against taxpayer had not even come into existence, and long before they had given notice of such liens. The court below, therefore, correctly ruled that the federal liens had priority.

As this Court stated in *United States* v. *Bess*, 357 U.S. 51, 56–57:

> [O]nce it has been determined that state law creates sufficient interests in the [taxpayer] to satisfy the requirements of § 3670, state law is inoperative to prevent the attachment of liens created by federal statutes in favor of the United States. * * *

See also, the discussion at pages 13–15 and 23–25 of the Government's brief in *United States* v. *Durham Lumber Co.*, No. 23, this Term.

In *United States* v. *Kings County Iron Works*, 224 F. 2d 232 (C.A. 2), which petitioners concede (Br.

COPY BOUND CLOSE IN CENTER

18), "on its facts * * * is admittedly indistinguishable from the case at bar," the court held that a federal tax lien was entitled to priority over a subsequently filed mechanic's lien. It expressly rejected the contention (p. 235) that "the trust fund given by these [New York] statutory provisions * * * divests the contractor of his property interest in his chose in action against the property owner * * * for federal tax purposes." The court stated (pp. 235–236):

> Until and unless the mechanic's lienor perfects his rights to the trust fund by filing a timely civil action in accordance with § 75 of N.Y. Lien Law, the contractor retains a paramount interest in the property in question, so that the debt belongs to him and is subject to federal levy as such.[7] * * *

[7] Petitioners seek to impair the force of that decision by relying upon language in the subsequent decision of the Second Circuit in *Fidelity & Deposit Co.* v. *New York City Housing Auth.*, 241 F. 2d 142, which they construe as indicating that in *Kings County* the court did not inquire whether state law created a property right in the taxpayer, but merely assumed that it did. (Br. 18–19.) The language relied upon by petitioners, however, is quoted out of context. When the entire paragraph (appearing at 241 F. 2d, p. 145) is read, it becomes clear that the property "right" to which the Second Circuit referred in *Fidelity & Deposit* was the right of the subcontractors, not the right of the taxpayer.

Petitioners further rely on the *Fidelity & Deposit* case affirmatively to support their argument that the taxpayer had no property interest in the fund. Such reliance is wholly misplaced. For there the construction contract contained a specific provision requiring the payment of subcontractors as a condition precedent to the right of the contractor to receive any part of the contract price. The Second Circuit accordingly held that, since the contractor was in default under this provision, he could not recover the contract price and that, conse-

B. THE FUND DEPOSITED BY THE OWNER IN COURT CONSTITUTED PROPERTY OF THE TAXPAYER TO WHICH THE FEDERAL TAX LIEN ATTACHED

As an alternative theory for establishing priority for their mechanic's liens, petitioners contend (Br. 25–27) that the fund of $2,200 which the owner paid into court represented property of the owner rather than of the taxpayer; and that since the federal lien attaches only to property of the taxpayer, it could not reach the fund. They argue that they also had a mechanic's lien on the real property (in addition to a "trust fund" claim against the indebtedness), which they brought suit to foreclose; and that the money which the owner deposited in court, representing the balance due under the contract, must be viewed as a substitute for the realty.

This argument in nothing more than a revised version of the contention, advanced at Special Term, and adopted by that court (R. 53), that the federal tax lien was in reality a lien against real property and was, therefore, not filed in the proper office under

---

quently, there was no debt due to the taxpayer to which the federal lien could attach. This conclusion was reached purely as a matter of state contract law and the court recognized that, under its earlier decision in *Kings County*, the trust fund rights of the subcontractors constituted only a lien which was junior to the federal tax lien.

In the instant case there were no comparable provisions in the contractual arrangements between the owner and the contractor, and the *Kings County* case is fully applicable. Petitioners' statement (Br. 20) that the parties to a construction contract may avoid the impact of the decision below merely by inserting a *Fidelity & Deposit* provision in their agreement, is beside the point. For assuming the correctness of *Fidelity & Deposit*, it is not unusual that parties by contract may change their respective property rights.

COPY BOUND CLOSE IN CENTER

state law. This argument, however, was rejected by the Appellate Division (R. 63) and by the Court of Appeals (R. 68), which ruled (*ibid.*) that the federal lien "was manifestly not asserted against Bottone's real property or any realty possibly owned by the taxpayer. It was asserted against the contractual obligation of Bottone to Fleetwood * * *." The money which the owner paid into court was the amount remaining unpaid under her contract with the taxpayer; it obviously constituted the payment of her indebtedness to the latter. As the court below held, this debt of $2,200 from the owner to the taxpayer constituted property of the latter, to which the federal tax lien attached. This being so, it is immaterial whether, for other purposes and in other contexts, it might also be viewed as in substitution for the owner's real property.

C. THERE IS NO OCCASION HERE FOR RE-EXAMINATION OF THE SETTLED RULE THAT FEDERAL LIENS HAVE PRIORITY OVER PREVIOUSLY FILED STATE-CREATED MECHANIC'S LIENS WHICH REQUIRE FURTHER STEPS FOR THEIR PERFECTION

Finally, petitioners urge (Br. 27–33) that if this Court accepts the holding below that the indebtedness of the owner to the contractors constitutes "property" of the latter, it should re-examine and overturn the settled rule that a federal tax lien has priority over a previously filed mechanic's lien if the latter is "inchoate" in the sense that additional steps are required to perfect it (see *supra*, p. 9, and the discussion of this rule at pp. 14–15 of the Government's brief in *United States* v. *Durham Lumber Co.*, No. 23, this

Term).[8] While we believe that the rule is correct and that petitioners have shown nothing which calls for its re-examination, the instant case would plainly not be an appropriate vehicle for doing so. For even if the Court were to change the rule, the result here would be the same—petitioner' liens would still be subordinate to the federal liens.

The federal tax liens in this case arose many months before any claims were asserted by any of the subcontractors and, indeed, before the subcontractors even agreed to perform the services or furnish the materials which their mechanic's liens cover. They were properly recorded in accordance with state law (R. 68), prior to the filing of petitioners' liens. This case, therefore, is governed by the principle—which petitioners do not challenge—that "the first in time is the first in right" (*United States* v. *New Britain,* 347 U.S. 81, 85). Since petitioners' liens were not "the first in time," it is immaterial whether, had they been so, they would nevertheless have been subordinate to the federal liens because they were still inchoate.

---

[8] Petitioners did not raise this issue in their petition, but limited themselves to the sole question whether the taxpayer's interest in the owner's indebtedness constituted "property" of the taxpayer. See Pet. 2, 6–17.

CONCLUSION

The judgment of the New York Court of Appeals should be affirmed.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
HOWARD A. HEFFRON,
A. F. PRESCOTT,
MYRON C. BAUM,
Attorneys.

SEPTEMBER, 1959

APPENDIX

Internal Revenue Code of 1939:

SEC. 3670. PROPERTY SUBJECT TO LIEN.

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

(26 U.S.C. 1952 ed., Sec. 3670.)

SEC. 3671. PERIOD OF LIEN.

Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time.

(26 U.S.C. 1952 ed., Sec. 3671.)

SEC. 3672. [as amended by Sec. 401, Revenue Act of 1939, c. 247, 53 Stat. 862, and Sec. 505, Revenue Act of 1942, c. 619, 56 Stat. 798]. VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASES, AND JUDGMENT CREDITORS.

(a) *Invalidity of Lien Without Notice.*—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector—

(1) *Under State or Territorial laws.*—In the office in which the filing of such notice is au-

COPY BOUND CLOSE IN CENTER

thorized by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law authorized the filing of such notice in an office within the State or Territory; or

(2) *With clerk of district court.*—In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law authorized the filing of such notice in an office within the State or Territory; or

* * * * *

(26 U.S.C. 1952 ed., Sec. 3672.)

New York Lien Law, 32 McKinney's Consolidated Laws of New York:

SEC. 3. *Mechanic's lien on real property*

A contractor, subcontractor, laborer, materialman, landscape gardener, nurseryman or person or corporation selling fruit or ornamental trees, roses, shrubbery, vines and small fruits, who performs labor or furnishes materials for the improvement of real property with the consent or at the request of the owner thereof, or of his agent, contractor or subcontractor, shall have a lien for the principal and interest, of the value, or the agreed price, of such labor or materials upon the real property improved or to be improved and upon such improvement, from the time of filing a notice of such lien as prescribed in this chapter. * * *

* * * * *

SEC. 4. *Extent of lien*

(1) Such lien shall extend to the owner's right, title or interest in the real property and improvements, existing at the time of filing the notice of lien, or thereafter acquired, except as hereinafter in this article provided. If an owner assigns his interest in such real property by a general assignment for the benefit

of creditors, within thirty days prior to such filing, the lien shall extend to the interest thus assigned. If any part of the real property subjected to such lien be removed by the owner or by any other person, at any time before the discharge thereof, such removal shall not affect the rights of the lienor, either in respect to the remaining real property, or the part so removed. If labor is performed for, or materials furnished to, a contractor or subcontractor for an improvement, the lien shall not be for a sum greater than the sum earned and unpaid on the contract at the time of filing the notice of lien, and any sum subsequently earned thereon. In no case shall the owner be liable to pay by reason of all liens created pursuant to this article a sum greater than the value or agreed price of the labor and materials remaining unpaid, at the time of filing notices of such liens, except as hereinafter provided.

* * * * *

SEC. 13. *Priority of liens.*

* * * (7) The moneys received by a contractor or subcontractor under any assignment of moneys or any part thereof, due or to become due under a contract for the improvement of real property, whether or not such assignment contains the covenant required by subdivision six of this section, are hereby declared to be trust funds in the hands of such contractor or subcontractor to be first applied to the payment of claims of subcontractors, architects, engineers, surveyors, laborers, and materialmen arising out of the improvement and to the payment of premiums on surety bond or bonds filed and premiums on insurance accruing during the making of the improvement. Any contractor or subcontractor and any officer, director or agent of any contractor or subcontractor who applies or consents to the application of such moneys for any other purpose

COPY BOUND CLOSE IN CENTER

and fails to pay claims hereinbefore mentioned, is guilty of larceny and is punishable as provided in section thirteen hundred and two of the penal law. Such trust may be enforced by civil action maintained as provided in article three-a of this chapter by any person entitled to share in the fund, whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement. For the purposes of a civil action only, the trust funds shall include the right of action upon an obligation for moneys due or to become due to a contractor or subcontractor, as well as moneys actually received by him.

Nothing in this subdivision shall be considered as imposing upon the assignee any obligation to see to the proper application of the moneys advanced under such assignment by the assignee.

* * * * *

SEC. 36–a. *Contractor who diverts funds guilty of larceny; civil remedy to enforce trust.*— The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement, and to the payment of premiums on surety bond or bonds filed and premiums on insurance accruing during the making of the improvement and any contractor and any officer, director or agent of any contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny and punishable as provided in section thirteen hundred and two of the penal law. Such trust may be enforced by civil action maintained as provided in article three-a of

this chapter by any person entitled to share in the fund, whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement. For the purpose of a civil action only, the trust funds shall include the right of action upon an obligation for moneys due or to become due to a contractor, as well as moneys actually received by him.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1939

COPY BOUND CLOSE IN CENTER